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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated April 23, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

USP =

DSub1 =

DSub2 =

DSub3 =

DSub4 =

FSub1 =

YCORP =

FCorp1 =

FCorp2 =

FCorp3 =

State A =

State B =

State C =

Country W =

Country X =

Country Y =

Country Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Year 1 =

Year 2 =

Interests =

Field 1 =

Region A =

Area 1 =

Area 2 =

Area 3 =

Agreement A =

Agreement B =

Agreement C =

Agreement D =

Agreement E =

aa =

bb =

cc =

dd =

ee =

ISSUE:

Is DSub4 taxable under section 367(a)(1) upon its reincorporation as FSub1, followed by FSub1's disposition of aa percent of its Interests to FCorp3, an unrelated foreign company?

CONCLUSION:

DSub4's reincorporation in Country X as FSub1 is treated as an "F" reorganization. Accordingly, DSub4 is deemed to have made an outbound transfer of assets that is fully taxable under section 367(a)(1), unless the assets qualify for the Active Trade or Business Exception under section 367(a)(3). Additional facts are needed to determine whether section 367(a)(3) is applicable.

If the exception is applicable, DSub4 would qualify for nonrecognition treatment under the Active Trade or Business Exception with respect to the bb percent of the Interests and other transferred assets that it retained. However, DSub4 should be taxable on the gain realized on the outbound transfer of assets that are re-transferred to FCorp3 because FSub1's disposition of such assets to FCorp3 constitutes a prohibited "subsequent transfer" under Reg. §1.367(a)-2T(c). If the disposition by FSub1 occurred within six months after its receipt, the initial transfer of such assets by DSub4 is taxable under section 367(a)(1). Even if the transfer by FSub1 occurred more than six months after its receipt, the result should be the same (i.e., taxation under section 367(a)(1)) using step transaction principles to aggregate the initial transfer by DSub4 with the later transfer by FSub1.

There are a number of other potential limitations to nonrecognition treatment, including: (i) the prohibition against transferring certain "hot" assets (e.g., inventory) under Reg. §1.367(a)-5T, (ii) branch loss recapture under Reg. §1.367(a)-6T, (iii) overall foreign source recapture under Reg. §1.904(f)-2(d), and (iv) dual consolidated loss recapture under Reg. §1.1503-2, which requires recapture of certain losses, not addressed by section 367(a) and section 904(f)(3), that were utilized by USP on its consolidated income tax return for prior years.

FACTS:

In Year 1, USP was a publicly traded domestic corporation, which owned one-hundred percent of the stock of DSub1, a domestic corporation. DSub1, in turn, owned one-hundred percent of the stock of each of DSub2, a Delaware corporation, and DSub3, a State A corporation.

At all relevant times, USP and its subsidiaries were engaged in the business of oil and gas exploration. According to the taxpayer, during this time it was USP's general philosophy to spread its risk, where possible, regarding its oil and gas exploration. activities. Such risk sharing generally took the form of farm-outs of exploration licenses whereby a third party would assume a share of the ownership of a license. Depending on the perceived value of the particular license, USP would normally seek some form of reimbursement for its previously incurred costs, either in the form of a cash payment or in the form of some degree of a carried interest.

DSub3 possessed a cc percent working interest in Area 1. Sometime during Year 1, after several years of exploration activity, DSub3 discovered and confirmed two wells in Field 1 located in the southern part of Area 1, which were tested at an aggregate of approximately dd barrels of oil per day. Also during Year 1, YCORP, a Country Y corporation affiliated with the government of Country Y, approved DSub3's application to declare Field 1 commercial with initial production from Field 1 expected to begin in Year 2.

According to information provided by the taxpayer, on Date 1, DSub2 and FCorp1 entered into a confidentiality agreement regarding discussions covering possible farm-out arrangements for the oil and gas fields located in Country W. One or more replacement confidentiality agreements were entered into on Date 7 between DSub2 and FCorp2.

On Date 3, DSub3, a State A corporation, merged into DSub4, a State B corporation, with DSub4 as the surviving corporation. Pursuant to taxpayer's § 6662 disclosure statement for the fiscal tax year ending on Date 13, the forgoing merger transaction was intended to qualify as a reorganization described in section 368(a)(1)(F) (the "First F Reorganization").

On Date 4 (one day after Date 3), DSub4 acquired a working interest in oil and gas properties located in Area 2 and Area 3 in connection with two separate association agreements between DSub4 and YCORP. As a result of such agreements, DSub4 acquired a cc percent Interest in each of Area 2 and Area 3. According to information included in taxpayer's annual report to shareholders, Area 2 and Area 3 covered an area of approximately ee acres and was contiguous to Area 1 in Country Y.

On Date 6, DSub4, a State B corporation, was reincorporated in Country X under a State B law (enacted Date 5) which enabled DSub4 to simultaneously de-register in State B and register as a corporation in Country X (after the reincorporation, DSub4 is hereinafter referred to as FSub1). Pursuant to the taxpayer's § 6662 disclosure statement for the fiscal tax year ending on Date 13, the forgoing reincorporation transaction was intended to qualify as a reorganization described in §368(a)(1)(F) (the "Second F Reorganization").

According to the taxpayer, on Date 8, representatives of FCorp2 met with representatives of USP in an unsolicited discussion regarding exploration acreage located in Region A. Following those discussions, USP entered into a confidentiality agreement dated Date 9 with FCorp1 allowing FCorp2 access to FSub1 documents and information on its exploration acreage.

On Date 10, USP and FCorp3, an unrelated corporation, entered into Agreement A, outlining the basic terms by which FCorp3 would farm-in and earn an interest in taxpayer's Interests in properties located in Country Y (including Area 1, Area 2, and Area 3), Country W, as well as other areas in Region A.

On Date 12, FSub1 and FCorp3 entered into Agreement B, providing that FCorp3 would make a cash payment to FSub1 and would provide additional funds to develop the Interests in Area 1, Area 2, and Area 3 in exchange for a aa percent Interest in FSub1's rights under the various association agreements with YCORP.

Pursuant to the terms of Agreement B, FSub1 and FCorp3 also entered into Agreement C, Agreement D, and Agreement E on Date 12 to conduct joint petroleum operations in Area 1, Area 2, and Area 3. Each of Agreement C, Agreement D, and Agreement E designated FSub1 as the operator and accorded each of FSub1 and FCorp3 the right and obligation to take their share of oil production in kind and to separately dispose of such share. The effective date of Agreement B and each of Agreement C, Agreement D, and Agreement E was Date 11. Article 13.1 of each of Agreement C, Agreement D, and Agreement E and Article 7.12 of Agreement B provides that the parties do not intend to create a partnership and, if they are regarded as a partnership for federal income tax purposes, each of FSub1 and FCorp3 agreed to elect out of the partnership provisions of subchapter K.

By deed of assignment between FSub1, FCorp3 and YCORP, FSub1 assigned to FCorp3 aa percent of FSub1's interests, rights, and obligations under the respective association agreements between FSub1 and YCORP.

LAW AND ANALYSIS

A. Section 367(a): General Rule.

Section 367(a)(1) provides that, if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. The result of the forgoing is that if section 367(a)(1) is applicable to the transfer, the transfer is taxable.

Reg. §1.367(a)-1T(f) provides that in a reorganization under section 368(a)(1)(F) where the transferor corporation is a domestic corporation and the acquiring corporation is a foreign corporation, there is considered to exist (i) a transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities, (ii) a distribution of the stock of the acquiring corporation by the transferor corporation to the shareholders of the transferor corporation, and (iii) an exchange by the transferor corporation's shareholders of the stock of the transferor corporation for stock of the acquiring corporation under section 354(a).

B. Section 367(a)(3): Active Trade or Business Exception.

Of the three deemed consequences described above, the only consequence that is potentially taxable under section 367(a) is the section 361(a) exchange (i.e., the deemed outbound transfer of assets by DSub4 to FSub1). With regard to such transfer, section 367(a)(3)(A) generally provides that, except as provided in regulations, section 367(a)(1) shall not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States (the "Active Trade or Business Exception"). Thus, if section 367(a)(3)(A) is applicable to the section 361(a) exchange, such asset transfer qualifies for nonrecognition treatment.

Reg. §1.367(a)-2T(a) provides that section 367(a)(1) shall not apply to property transferred to a foreign corporation if (i) such property is transferred for use by that corporation in the active conduct of a trade or business outside of the United States, (ii) the U.S. person that transfers the property complies with the reporting requirements of section 6038B and the regulations thereunder, and (iii) there is no subsequent re-transfer of such property except as authorized under Reg. §1.367(a)-2T(c). Where each of the foregoing requirements are satisfied, the asset transfer would qualify for nonrecognition treatment under the Active Trade or Business Exception.

Even if the taxpayer fails to satisfy the requirements of Reg. §1.367(a)-2T, it may qualify for the oil and gas working interest exception generally applicable to the transfer of oil and gas working interests under Reg. §1.367(a)-4T(e)(1). Such

exception generally provides that a working interest in oil and gas properties will not be considered to be transferred for use in the active conduct of a trade or business unless, at the time of the transfer, the transferor is regularly and substantially engaged in exploration for and extraction of minerals, either directly or through working interests in joint ventures, other than by reason of the property that is transferred. Because Reg. §1.367(a)-1T(f) deems every F reorganization to be a transfer of all of the transferor corporation's assets to the acquiring corporation, it would not be possible for DSub4, as transferor, to satisfy the active conduct of a trade or business under Reg. §1.367(a)-4T(e). Reg. §1.367(a)-4T(e)(4), however, provides that oil and gas interests not described in Reg. §1.367(a)-4T(e) may nonetheless qualify for the exception to section 367(a)(1) contained in Reg. §1.367(a)-2T. Accordingly, since Reg. §1.367(a)-4T(e)(1) is inapplicable, the discussion below is limited to the rules under Reg. §1.367(a)-2T, the Active Trade or Business Exception.

1. Active conduct of trade or business requirement.

At the outset, we note that the determination of whether the transferee foreign corporation satisfies the Active Trade or Business Exception is highly factual in nature. Because the determination is so factual, such issue is specifically identified in Rev. Proc. 99-7, 1999-1 I.R.B. 226, as an issue for which letter rulings or determination letters will not ordinarily be issued.

To satisfy the first prong of the Active Trade or Business Exception, FSub1 must satisfy each of four requirements, including: (i) the trade or business requirement, (ii) the active conduct requirement, (iii) the foreign conduct requirement, and (iv) the use requirement.

a. The trade or business requirement.

The trade or business requirement must be determined under all of the facts and circumstances. Reg. §1.367(a)-2T(b)(2) generally provides that, to constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. Based on the information provided, it appears that FSub1 satisfies the trade or business requirement. An examination of the facts should be undertaken to confirm that the activities performed by FSub1 include every operation which forms a part of, or a step in, a process associated with oil and gas exploration.

b. The active conduct requirement.

The active conduct requirement must be determined under all of the facts and circumstances. Reg. §1.367(a)-2T(b)(3) generally provides that, a corporation actively conducts a trade or business only if the officers and employees of the

corporation or related entities (who are made available to and supervised on a day-to-day basis by, and whose salaries are paid by or reimbursed to the lending related entity by the transferee foreign corporation) carry out substantial managerial and operational activity. Reg. §1.367(a)-2T(b)(3) generally provides that, in determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, the activities of independent contractors shall be disregarded. From the facts provided, it is unclear whether FSub1 has any employees or whether independent contractors perform substantially all managerial and operational activities. If such management activities were provided by related entities, including USP and, or subsidiaries of USP, you should also confirm whether such loaned or seconded officers and employees were supervised on a day-to-day basis by employees of FSub1, and that the salaries of such loaned or seconded officers and employees were paid by, or reimbursed to, the lending related entity by FSub1.

c. The foreign conduct requirement.

The foreign conduct requirement must be determined under all of the facts and circumstances. Reg. §1.367(a)-2T(b)(4) generally provides that the primary managerial and operational activities of the trade or business must be undertaken outside the United States and, immediately after the transfer, the transferred assets must be located outside the United States. Reg. §1.367(a)-2T(b)(4) further provides that incidental items of transferred property located in the United States may be considered to have been transferred for use in the active conduct of a trade or business outside of the United States; provided, however, the primary managerial and operational activities of the trade or business are undertaken outside the United States, and substantially all of the transferred assets are located outside the United States. From the facts provided it is unclear whether the primary managerial and operational activities of FSub1's trade or business are conducted outside the United States. It is also unclear whether, immediately after the transfer, there are any transferred assets, other than incidental items of transferred property, that are not located outside the United States. An examination of the facts and circumstances should be undertaken to determine the foregoing.

d. The use requirement.

The use requirement must be determined under all of the facts and circumstances. Reg. §1.367(a)-2T(b)(5) generally provides that property is used or held for use in a foreign corporation’s trade or business if it is (i) held for the principal use of promoting the present conduct of the trade or business, (ii) acquired and held in the ordinary course of the trade or business, or (iii) otherwise held in a direct relationship to the trade or business. Generally, Reg. §1.367(a)-2T(b)(5) further provides that property is considered held in a direct relationship to a trade or business if it is held to meet the present needs of that

trade or business and not its anticipated future needs. From the facts provided it is unclear whether all of the transferred property satisfies the use requirement; however, subject to the discussion below regarding post-transfer disposition of transferred property, it does appear that the Interests in Area 1, Area 2, and Area 3 would satisfy the use requirement. An examination of the remaining transferred property should be undertaken to determine whether each such item of transferred property satisfies the use requirement.

2. Section 6038B: Reporting Requirement.

As noted above, to satisfy the second prong of the Active Trade or Business Exception, a taxpayer must comply with the applicable reporting requirements under section 6038B. Reg. §1.6038B-1T(b)(2) generally provides that a failure to comply with the requirements of section 6038B includes (i) the failure to report at the proper time and in the proper manner any material information required to be reported under the rules of Reg. §1.6038B-1T, or (ii) the provision of false or inaccurate information in purported compliance with the requirements of Reg. §1.6038B-1T. (Please note, that all references herein to the regulations under Section 6038B are to the regulations in effect for the tax year ending on Date 13.)

The regulations in effect at such time under Reg. §1.6038-1T(c) generally required a U.S. person that transferred property to a foreign corporation in an exchange described in section 367(a)(1) to provide information regarding (i) the identity of the transferor, (ii) the identity of the transferee, (iii) a general description of the transfer and any wider transaction of which it forms a part, (iv) a description of the consideration received by the U.S. person making the transfer, including the estimated fair market value of such consideration, (v) a description of the property transferred including the estimated fair market value and adjusted tax basis broken down into categories for active business property, stock or securities, depreciated property, property to be leased, property to be sold, transfers to FSCs, and tainted property such as, inventory, installment obligations, foreign currency, and leased property, and (vi) if the property transferred is property of a foreign branch with previously deducted losses, a detailed calculation of the sum of the losses incurred by the foreign branch before the transfer, and a detailed calculation of any reduction of such losses in accordance with Reg. §1.367(a)-6T(d) and (e), and the character of such gain. Similarly, separate rules are specified under Reg. §1.6038B-1T(d) for transfers of intangible property subject to section 367(d).

USP included Form 926 with its income tax return for the fiscal year ending on Date 13; however, we note that taxpayer failed to provide all of the information required by section 6038B and Reg. §1.6038B-1T, such as a schedule of the types of assets transferred broken down into categories for active business property, stock or securities, depreciated property, property to be leased, property to be sold, transfers to FSCs, and tainted property such as, inventory, installment obligations,

foreign currency, and leased property. Pursuant to the authority of Reg. §1.6038B-1T(f)(3) in effect for the fiscal year ending on Date 13, it is in your discretion to determine whether the taxpayer has satisfied the reporting requirement. Accordingly, we do not express an opinion as to whether taxpayer has satisfied the reporting requirements under section 6038B.

3. No Prohibited "Subsequent Transfer" Rule.

Even if taxpayer satisfies the first and second prong of the Active Trade or Business Exception, section 367(a)(1) would continue to be applicable if FSub1 subsequently re-transferred such property, unless such subsequent transfer was not a prohibited subsequent transfer under Reg. §1.367(a)-2T(c).

We note at the outset that FSub1 transferred aa percent of its Interests in Area 1, Area 2, and Area 3 to FCorp3 after the initial transfer from DSub4 to FSub1 and retained the remaining bb percent Interests in Area 1, Area 2, and Area 3. As discussed further below, section 367(a)(1) is not applicable to the bb percent Interests retained by FSub1 (i.e., the Interests other than the aa percent Interests assigned to FCorp3) to the extent such retained Interests otherwise satisfied the first and second prong of the Active Trade or Business Exception. With regard to FSub1's subsequent transfer of aa percent of its Interests in Area 1, Area 2, and Area 3, we consider below the rules under Reg. §1.367(a)-2T(c)(1).

Under Reg. §1.367(a)-2T(c)(1), a subsequent transfer is constructively deemed to be part of the same transaction as the initial transfer (and, thus, a prohibited subsequent transfer) if such subsequent transfer occurs within six months of the initial transfer. Therefore, if after DSub4 transferred property to FSub1, FSub1 subsequently transferred such property to another person within six months from the date of the initial transfer, such subsequent transfer would taint the initial transfer of property and would render such initial transfer taxable under section 367(a)(1) to the extent of such subsequent transfer, unless the subsequent transfer qualifies for the exception under Reg. §1.367(a)-2T(c)(2). Under Reg. §1.367(a)-2T(c)(1), a subsequent transfer that occurs more than six months after the initial transfer may also taint the initial transfer using step transaction principles, unless an exception applies.

In the present case, FSub1 made a subsequent transfer of aa percent of its Interests in Area 1, Area 2, and Area 3 to FCorp3 after the initial transfer from DSub4 to FSub1. Although Agreement B and each of Agreement C, Agreement D, and Agreement E were executed on Date 12, which was more than six months after the initial transfer, the effective date of each such transfer was on Date 11, which was less than six months after the initial transfer (i.e., the Second F Reorganization). Moreover, the economic terms of the subsequent transfer were negotiated on Date 10, which was less than 4 months after the initial

transfer. Based on the forgoing, we are unable to conclusively determine whether such subsequent transfer occurred within six months, or was more than six months after, the initial transfer (i.e., the Second F Reorganization). We believe that a critical factor in the determination of the actual date of the subsequent transfer is the date in which FCorp3 acquired property rights in the Interests in Area 1, Area 2, and Area 3 under applicable local or foreign law. We note that each of Agreement C, Agreement D, and Agreement E include a provision incorporating State C law.

If the subsequent transfer occurred more than six months after the initial transfer, certain factors indicate that the application of step-transaction principles is warranted. Factors in support of an application of step-transaction principles include the following. First, information submitted by taxpayer indicates that it was USP's general philosophy to spread its risk, where possible, regarding its oil and gas exploration activities, although it is also noted that the taxpayer's Senior Vice President and Chief Financial Officer stated in writing that the transfer of assets to FSub1 was not consummated with any expectation or prior knowledge of the possibility of the FCorp3 proposal. Second, after several years of exploration activity, DSub3 discovered and confirmed two wells in Field 1 in the southern part of Area 1 and such wells were tested at an aggregate of approximately dd barrels of oil per day. Third, subsidiaries of USP and entities related to FCorp2 were already actively engaged in ongoing discussions over joint exploration efforts in Country W at least three months prior to the date of the Second F Reorganization. Fourth, the reincorporation of DSub4 as FSub1 occurred just twenty days after DSub3 acquired a working interest in oil and gas properties located in Area 2, and Area 3. Fifth, Area 1, Area 2, and Area 3 are contiguous; therefore, an inference may be drawn that if several confirmed production wells were identified in Area 1, there would be a substantially greater likelihood that productive wells also existed in Area 2, and Area 3. Finally, Agreement B, Agreement C, Agreement D, and Agreement E each include an effective date of Date 11 with financial terms substantially similar to those set forth on the term sheet executed by the parties almost two months earlier. We note that other factors may be relevant as well.

Based on the foregoing factors and a further development of the facts, including whether the subsequent transfer occurred within six months of, or more than six months after, the date of the initial transfer, it may be appropriate to treat FSub1's subsequent transfer of a aa percent Interest in Area 1, Area 2, and Area 3 as tainting such initial transfer of property and, as a result, rendering such initial transfer of property (to the extent such properties were subsequently transferred to FCorp3) as a taxable transfer described in section 367(a)(1). We believe that the exception contained in Reg. §1.367(a)-2T(c)(2) would not change the results discussed herein.

C. Exceptions to Active Trade or Business Exception.

In addition to the above rules for determining whether the Active Trade or Business Exception applies, there are two additional statutory exceptions to section 367(a)(1) that may apply.

1. Tainted Asset Exception.

In conjunction with your factual analysis of whether the transfer of assets from DSub4 to FSub1 satisfies the Active Trade or Business Exception, you should consider the provisions of section 367(a)(3)(B), which excepts the transfer of certain assets from the Active Trade or Business Exception and the concomitant nonrecognition treatment under section 367(a)(3)(A).

With regard to section 367(a)(3)(B), Reg. §1.367(a)-5T(a) generally provides that section 367(a)(1) shall apply to the transfer of inventory, certain installment obligations, foreign currency, and certain leased tangible property ("Tainted Assets") regardless of whether such Tainted Assets are transferred for use in the active conduct of a trade or business outside the United States. Based on the limited information provided on Form 926, we are unable to determine the extent to which DSub4 is deemed to have transferred Tainted Assets to FSub1 in connection with the Second F Reorganization.

We note, however, that for the year at issue, a description of all such Tainted Assets (whether individually or by category), together with the fair market value and adjusted basis for such assets, was required under Reg. §1.6038B-1T(c) to be included on such Form 926. An examination of the individual assets transferred from DSub4 to FSub1 should be undertaken to determine the extent to which such assets are Tainted Assets for which gain recognition would be required.

2. Branch Loss Recapture Exception.

In conjunction with your factual analysis of whether the transfer of assets from DSub4 to FSub1 satisfies the Active Trade or Business Exception, you should consider the provisions of section 367(a)(3)(C), which requires gain recognition for the transfer of a foreign branch with previously deducted losses (the "Branch Loss Recapture Rule"). For purposes of section 367(a)(3)(C), Reg. §1.367(a)-6T(a) generally provides that if a U.S. person transfers any assets of a foreign branch described in section 367(a)(1), then the transferor shall recognize gain regardless of whether the assets of the foreign branch are transferred for use in the active conduct of a trade or business outside the United States. Reg. §1.367(a)-6T(g) generally provides that the term "foreign branch" must be determined by an examination of all of the facts and circumstances. We note that information submitted by the taxpayer on Form 926 states that the taxpayer's oil and gas exploration constitutes a foreign branch. Accordingly, taxpayer is subject to gain

recognition on the amount of its previously deducted losses as determined in accordance with the provisions of Reg. §1.367(a)-6T. We note also that, Reg. §1.367(a)-6T(e)(5) provides rules to coordinate recapture of income under the Branch Loss Recapture Rule with recapture of income under the overall foreign loss recapture rule of section 904(f)(3) (discussed further below).

Based on the limited information provided on Form 926, we are unable to determine the extent to which taxpayer is subject to the Branch Loss Recapture Rule in connection with the Second F Reorganization. We note, however, that for the year at issue, Reg. §1.6038B-1T(c) required the taxpayer to include on such Form 926 a description of the property (whether individually or by category) utilized in connection with the foreign branch together with a breakdown of such property's fair market value and adjusted tax basis, a calculation of the sum of the losses incurred by the foreign branch before the transfer, a detailed calculation of any reduction of such losses in accordance with Reg. §1.367(a)-6T(d) and (e), and the character of such gain. An examination of the foregoing should be undertaken to determine the extent to which the Branch Loss Recapture Rule would require gain recognition pursuant to the rules set forth in section 367(a)(3)(C).

D. Other Considerations.

1. Section 367(d).

We have no knowledge of whether any intangible property (as defined in section 936(h)(3)) was transferred by DSub4 in connection with the reincorporation. The Form 926 was incomplete and did not disclose the transfer of any such property. If any intangible property was transferred, section 367(d) applies to such transfer without regard to the Active Trade or Business Exception.

2. Section 904(f)(3).

In conjunction with your factual analysis of whether gain must be recognized on the section 361(a) outbound transfer of assets from DSub4 to FSub1, you should also consider the overall foreign loss recapture rule under section 904(f)(3) and Reg. §1.904(f)-2(d) (the "Overall Foreign Loss Recapture Rule"). Reg. §1.904(f)-2(d) generally provides that, if property, which has been used predominantly outside the United States in a trade or business, is disposed of during any taxable year (regardless of whether gain or loss is otherwise recognized), the taxpayer is deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition by reason of such disposition. Under Reg. §1.904(f)-2(d)(2), the amount of such income must be determined after applying the rules under Reg. §1.904(f)-2(c), which to the extent applicable, treats such recaptured overall foreign loss as income from sources within the United States. As previously noted in the

discussion above regarding the Branch Loss Recapture Rule, the income required to be recognized in accordance with the Overall Foreign Loss Recapture Rule under section 904(f)(3) may be applied to reduce the amount of recapture in accordance with the Branch Loss Recapture pursuant to the provisions of Reg. §1.367(a)-6T(e)(5).

3. Section 1503(d).

In conjunction with your factual analysis of whether gain must be recognized on the section 361(a) outbound transfer of assets from DSub4 to FSub1, you should also consider the dual consolidated loss rules under section 1503(d).

We note that USP, as common parent of a consolidated group of corporations, filed a consolidated income tax return that included DSub4 up to the date of the Second F Reorganization. We also note that USP filed an agreement under Reg. §1.1503-2(g)(2)(i) with respect to DSub4's Country Y branch, which is a separate unit, within the meaning of Reg. §1.1503-2(c)(3)(i)(A), and is also a dual resident corporation within the meaning of Reg. §1.1503-2(c)(2).

By filing an agreement under Reg. §1.1503-2(g)(2)(i), USP agreed to be bound by the loss recapture rules under Reg. §1.1503-2(g)(2)(vii) upon the occurrence of a triggering event described in Reg. §1.1503-2(g)(2)(iii). The loss recapture rule under Reg. §1.1503-2(g)(2)(vii) generally requires taxpayers to recapture and report as income the total amount of the dual consolidated loss to which a triggering event applies on its income tax return for the taxable year in which the triggering event occurs together with statutory interest from the date of the tax year in which the dual consolidated loss gave rise to a tax benefit for U.S. income tax purposes (the “Dual Consolidated Loss Recapture Rule”).

By reincorporating in Country X, DSub4 is treated as transferring one-hundred percent of its assets to FSub1 in an exchange of assets described in section 361(a). We also note that such reincorporation caused DSub4 to leave the consolidated group in which USP is the common parent. As a result of such reincorporation, a triggering event occurred, within the meaning of Reg. §1.1503-2(g)(2)(iii)(A)(5) (the “Triggering Event”).

A final determination can be made that a triggering event has occurred, however, only if the taxpayer failed to rebut the presumption of a triggering event under Reg. §1.1503-2(g)(2)(iii)(B) by demonstrating that the losses, expenses, or deductions of the foreign branch could not be carried over or otherwise used under the laws of the foreign country. We note, however, that in order to exercise its rebuttal rights, Reg. §1.1503-2(g)(2)(iii)(B) further provides that the taxpayer must attach documents demonstrating such facts to its timely filed U.S. income tax return for the year in which the putative triggering event occurred. Based on the

information provided, it does not appear that taxpayer has exercised its rebuttal rights under Reg. §1.1503-2(g)(2)(iii)(B) with respect to the Triggering Event because no such documents were attached to the taxpayer's timely filed U.S. income tax return.

Even though a triggering event is deemed to occur under Reg. §1.1503-2(g)(2)(iii)(A)(5), Reg. §1.1503-2(g)(2)(iv) includes two exceptions wherein a triggering event shall not constitute a triggering event for purposes of the Dual Consolidated Loss Recapture Rule under Reg. §1.1503-2(g)(2)(vii). The first relevant exception is applicable where the assets that are the subject of the triggering event are acquired by a member of the transferor's consolidated group (the "Consolidated Group Exception"). Pursuant to the Second F Reorganization, FSub1 acquired the assets from DSub4. As a foreign corporation, FSub1 was not an includible corporation within the meaning of section 1504(b) for purposes of the consolidated return rules. Therefore, the Triggering Event was ineligible for the Consolidated Group Exception. The second relevant exception is applicable where the assets that are the subject of the triggering event are acquired by an unaffiliated domestic corporation or a new consolidated group and the transferor and transferee enter into a closing agreement with the Internal Revenue Service (the "Closing Agreement Exception"). Because FSub1 is a foreign corporation, the Triggering Event does not qualify for the Closing Agreement Exception. Accordingly, USP was required to comply with the Dual Consolidated Loss Recapture Rule upon the occurrence of the Triggering Event. Such loss recapture amount was required to be included in income for the fiscal year ending on Date 13.

To the extent that USP is required to include an amount in gross income in accordance with the Dual Consolidated Loss Recapture Rule, we note that the Preamble to the final regulations under Reg. §1.1503-2 (T.D.8434) (Sept. 9, 1992) generally provides that under Reg. §1.1503-2(g)(2)(vii)(B), if the triggering event also results in loss recapture under section 367(a)(3)(C) or section 904(f), the income recognized under those sections may be applied to reduce the amount of recapture under Reg. §1.1503-2(g)(2)(vii). Finally, we note that Reg. §1.1503-2(g)(2)(vii)(D) generally provides that recapture income is treated as ordinary income having the same source and falling within the same separate category under section 904 as the dual consolidated loss being recaptured.

An examination of the foregoing should be undertaken to confirm whether a triggering event occurred, and, if applicable, whether gain recognition would be required pursuant to the Dual Consolidated Loss Recapture Rule under Reg. §1.1503-2(g)(2)(vii).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call (202) 622-3860.

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